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SUBJECT: GOA'S 2007 AND 2008 BUDGETS - ANALYSIS AND OUTLOOK

REFS: A) VIENNA 0979 B) VIENNA 0088 C) VIENNA 0187

Summary

¶1. The coalition government's 2007 and 2008 budgets foresee federal deficits of 1.3% and 1.2% of GDP, respectively. The budgets represent small steps towards a balanced budget, a goal that the GoA still maintains. However, the GoA now expects to achieve a balanced budget only by 2010. Finance Minister Wilhelm Molterer has ruled out tax cuts in the short-term, pledging to use windfall tax revenues from stronger than expected economic growth (3.0%) in 2007 to reduce the budget deficit. The Austrian National Bank, the EU Commission, and the IMF have criticized the slow progress towards a balanced budget given robust economic growth. Progress on administrative reform remains crucial for meaningful deficit reduction. End Summary.

The 2007 and 2008 Budgets

¶2. With the votes of the governing coalition parties - the Social Democratic Party and People's Party - Parliament recently approved the GoA's budgets for 2007 and 2008. The October 2006 parliamentary elections and subsequent coalition negotiations delayed the submission of the 2007 budget. Since January 1, the GoA had been operating under a continuing resolution. Although the GoA normally presents an out-year budget in the autumn, it decided to submit the 2008 budget now to minimize ongoing political skirmishing over specific budget items.

¶3. The 2007 budget projects revenues of Euro 65.7 billion ($88.8 billion at the current exchange rate of $1.35 for Euro 1.00), expenditures of Euro 69.6 billion ($94.0 billion), and a deficit of Euro 3.9 million ($5.2 million). The 2008 budget projects revenues of Euro 66.9 billion ($90.4 billion), expenditures of Euro 69.9 billion ($94.5 billion), and a deficit of Euro 3.0 million ($4.1 million). The federal budget deficit, according to the EMU's Maastricht definition, will be 1.3% of GDP in 2007 (1.5% in 2006) and 1.2% in 2008. Pursuant to the GoA's 2006-2010 Domestic Stability Pact, state governments and other public entities should produce a combined surplus of 0.4-0.5% of GDP, for a total public sector deficit of 0.9% of GDP in 2007 and 0.7% in 2008.

¶4. Federal government debt should rise from Euro 145.3 billion ($196.4 billion) at the end of 2006 to Euro 152.8 billion ($206.5 billion) in 2008, equivalent to 56.7% of GDP. The consolidated

public sector debt (encompassing all levels of government, according to the EMU's Maastricht definition) is projected to sink from 62.2% of GDP in 2006 to 59.9% in 2008.

¶5. The 2007 and 2008 budgets are based on the Austrian Institute for Economic Research's (WIFO) economic projections from December 2006 (ref B). WIFO forecast GDP growth of 2.7% in 2007 and 2.3% in 2008, with unemployment rates of 4.6% and 4.5%. However, subsequent forecasts in March (ref A) are more optimistic, indicating real GDP growth of 3.0% in 2007 and 2.7% in 2008, and unemployment rates of 4.2% and 4.1%.

Line item highlights

Defense

¶6. The MoD will receive a 24.3% increase in its budget to Euro 2.25 billion in 2007, compared to Euro 1.73 billion in 2006. However, the defense budget will decrease by 9.5% in 2008 to Euro 2.04 billion. In the 2007 budget, Euro 1.1 billion are for personnel, Euro 455 million for operations, and Euro 697 million for investments, of which Euro 467 million are for the first payments of the 18 new interceptors. The defense budget equals 0.84% of 2007 projected GDP (0.68% in 2006) and 0.73% of 2008 forecasted GDP. Excluding the expenditures for the Eurofighters, the MoD budget would only be Euro 1.78 billion in 2007 and Euro 1.79 billion in 2008, or 0.66% and 0.64% of GDP, respectively.

EU Contributions

¶7. The budget includes Austrian contributions to the EU in the amount of Euro 2.4 billion in 2007 and Euro 2.5 billion in 2008. Return payments from the EU, e.g., for agriculture and structural support, should amount to Euro 1.8 billion in both years. Austria's net contributions will therefore be approximately Euro 558 million in 2007 and Euro 688 million in 2008.

Civil Service, Pensions, and Social Spending

¶8. In line with election promises to hire additional police and teachers, the number of civil service positions will increase by 6,000 to 136,600 in 2007 and fall slightly in 2008 to 136,000. GoA expenditures for civil service salaries will amount to Euro 8.0 billion in both 2007 and 2008. In addition, the GoA has to pay for civil service pensions and for pensions of outsourced former civil servants of the federal railroad, the post and telecom and other privatized companies. The federal government also has to refund state governments for teachers' salaries and pensions. GoA expenditures on active personnel will be Euro 11.1 billion in 2007 and Euro 11.2 billion in 2008. Civil service pensions, including outsourced and refunds, will reach Euro 8.1 billion in 2007 and Euro 8.3 billion in 2008. Total pension expenditures will be Euro 19.3 billion in 2007 and Euro 19.5 billion in 2008, or almost 28% of total budget expenditures.

¶9. In addition to the above mentioned GoA expenses for civil service pensions, the GoA will contribute Euro 6.5 billion in 2007 and Euro 6.8 billion in 2008 to the social insurance system for pensions. The GoA's total social spending, excluding civil service expenditures, will be Euro 23.5 billion in 2007 and Euro 23.6 billion in 2008, almost 34% of all budget expenditures.

Outlook-2009 and Beyond

¶10. In out-years, the GoA aims to reduce the consolidated public sector deficit to 0.2% in 2009, with a surplus of 0.4% in 2010. The consolidated public sector debt should ease from 62.2% of GDP in

2006 to 56.8% in 2010. Despite these optimistic projections, the EU Commission recently criticized Austria's slow progress towards a balanced budget, given current robust economic cycle. The IMF also recently criticized the GoA's limited short-term consolidation efforts and the delay in its aim to achieve a balanced budget from 2008 to 2010. The IMF recommended streamlining within the various levels of government. Austrian National Bank Governor Klaus Liebscher has also seconded the criticism from the EU Commission and the IMF regarding modest deficit reduction efforts. Liebsher called for more progress on administrative reform and warned against reform standstill in view of ongoing globalization trends and the looming budgetary challenges of an ageing society.

¶11. Vice-Chancellor and Finance Minister Wilhelm Molterer announced that he will use windfall tax revenues from the better than expected economic growth for deficit reduction, ruling out income or corporate tax cuts without a consolidated budget. Molterer added that, with strong tax revenues, the GoA hopes to implement a tax cut in 2010, while achieving a balanced budget.

Comment

¶12. The GoA's budgets for 2007 and 2008 represent a trade-off between slower deficit reduction and additional GoA expenditures for education, and science and research. The 2007 and 2008 budgets are further small steps towards a balanced budget. However, the GoA continues to postpone the timeline for a balanced budget. To achieve a balanced budget by 2010, the GoA will need to slash spending in 2009 and 2010, just as economic growth and tax revenues should slow. To achieve meaningful deficit reduction, progress on administrative reform appears crucial, although this will require political fortitude.

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